

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
CLONE ENTERPRISES, INC. :
for Revision of Determinations or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1984 :
through August 31, 1987. :

In the Matter of the Petition :
of :
BRUCE FILASKI, :
AS OFFICER OF CLONE ENTERPRISES, INC. :
for Revision of Determinations or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1984 :
through August 31, 1987. :

DETERMINATION

In the Matter of the Petition :
of :
BRADLEY FILASKI, :
AS OFFICER OF CLONE ENTERPRISES, INC. :
for Revision of Determinations or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1984 :
through August 31, 1987. :

In the Matter of the Petition :
of :
WILLIAM FILASKI, :
AS OFFICER OF CLONE ENTERPRISES, INC. :
for Revision of Determinations or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1984 :
through August 31, 1987. :

Petitioner Clone Enterprises, Inc., 3601 Hempstead Turnpike, Levittown, New York 11756, filed a petition for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1984 through August 31, 1987 (File No. 807257).

Petitioners Bruce Filaski, Bradley Filaski and William Filaski as officers of Clone Enterprises, Inc., 2193 Hillside Avenue, Bellmore, New York 11710, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1984 through August 31, 1987 (File Nos. 807259, 807260 and 807261).

A consolidated hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York on January 10, 1991 at 9:30 A.M., with all briefs to be filed by April 26, 1991. Petitioners appeared by Melvin Koenig. The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

ISSUE

Whether the audit was reasonably calculated to reflect tax due from petitioners and, if so, whether petitioners have established any error in the audit methodology or results.

FINDINGS OF FACT

On September 10, 1987, the Division of Taxation ("Division") issued to petitioner, Clone Enterprises, Inc. ("Clone"), a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period June 1, 1984 through August 31, 1984, assessing tax due of \$13,582.64 plus penalty and interest. On the same date, notices of determination were issued to petitioners William Filaski, as secretary of Clone, Bruce Filaski, as president of Clone, and Bradley Filaski, as vice president of Clone, assessing tax, penalty and interest in the same amounts as those assessed against Clone.

On December 20, 1987, the Division issued two additional notices of determination to Clone. The first notice assessed tax in the amount of \$174,704.02 for the period September 1, 1984 through August 31, 1987 plus penalty and interest. The second notice assessed an additional penalty in the amount of \$13,433.93 for the period June 1, 1985 through August 31,

1987. Also on December 20, 1987, the Division issued two notices each to petitioners William Filaski, Bruce Filaski and Bradley Filaski, assessing tax, penalty, interest and additional penalties in amounts identical to those assessed against the corporation.

The audit at issue followed on the heels of an earlier audit of Clone for the period September 1, 1981 through May 31, 1984. During the earlier audit, Clone operated a disco named "Feathers" which served alcoholic beverages. On selected nights, Feathers operated a teen disco, selling only soda. In late December 1986, Feathers stopped selling alcoholic beverages and began operating strictly as a teen disco called W. W. Flash.

On April 24, 1987, an auditor called Clone's business telephone number and received a recorded message, stating that Clone was now operating a teen disco on Friday, Saturday and Sunday nights. The message also stated that the business was offering home catering and provided a telephone number for that service. The auditor left a message on Clone's answering machine, asking Clone to call her. She then called the caterer's number and spoke to a woman named Jeannette. Jeanette stated that she saw the operators of the teen disco on weekends. The auditor asked Jeanette to have someone from Clone return her call, but no one did. The auditor called Clone's business telephone two more times and left messages on the answering machine asking to have her calls returned. She also sent Clone two short notes, which she called "flashers", that again asked Clone to contact her in connection with a sales tax audit. She received no communications whatsoever from Clone.

On or about June 12, 1987, the Division mailed an appointment letter to Clone, scheduling a field examination of all books and records pertaining to Clone's sales tax liability for the period June 1, 1984 through May 31, 1987. Clone was asked to make available for the Division's review all journals, ledgers, sales invoices, purchase invoices, cash register tapes, guest checks and bank statements maintained by Clone for the audit period. In addition, the letter requested completion of a bar fact sheet and questionnaire, information with regard to Clone's catering business and a record of booking reservations.

On June 29, 1987, the auditor went to Clone's place of business where she obtained

Bruce Filaski's phone number and left a flasher asking Mr. Filaski to contact her. She called Mr. Filaski on June 30, 1987 and spoke to his brother Bill Filaski. She left a message asking Bruce Filaski to call her. On July 2, 1987, she called Bruce Filaski again, this time with some success. She advised him that the Division was conducting an audit of Clone's books and records. She was told that Clone's accountant, Melvin Koenig, was in Florida and unavailable for an audit. The auditor and Mr. Filaski discussed the possibility of having Mr. Koenig return to New York for the audit or of Clone's obtaining the services of a different accountant. Mr. Filaski stated that he would speak to Mr. Koenig.

On July 7, 1987, the auditor returned an earlier telephone call from Mr. Koenig. He informed her that he had just become aware of the audit and would not return to New York until October. He asked that the audit be postponed until then. The auditor refused a postponement. She then asked Mr. Koenig to provide the Division with copies of Clone's Federal income tax returns for the audit years. Mr. Koenig declined to do so, stating that he would provide them in October when he returned.

Since the Division had no books and records to review, it decided to conduct an observation test to estimate Clone's sales tax liability. The test was performed by two auditors on Wednesday, August 26, 1987, from 7:30 P.M. to 1:00 A.M. The auditors made notes of their observation of the premises. The premises contained a bar with 22 bar stools and 8 sets of tables and chairs. They saw three video game machines and a cigarette machine. There were signs in the disco advertising live bands on Wednesday nights. In addition, there was an advertisement indicating that the disco could be booked for parties with catering by Jeanette and also that Clone arranged for home parties with complete catering and the services of a disc jockey and two assistants. The auditors saw three cash registers at the bar and one at the entrance. The auditors' notes indicate that the disco was open for business on Wednesday and Saturday nights.

One auditor stood at the entrance to the disco and physically counted customers entering the premises. Her count was divided into two categories, those paying the full price of \$12.00

and those possessing a V.I.P. card who paid a reduced admission fee of \$10.00. Total admission receipts of \$2,576.00 were computed based on the auditor's count. While standing at the entrance, the auditor noted that the cashier received phone calls from persons inquiring about renting the disco for parties. In addition several persons came in to view the premises with a view towards renting it for catered parties. A second auditor was stationed at the bar and counted the number of sodas sold at \$1.00 apiece. At the end of the evening, the auditor calculated soda sales of \$144.00. Total sales receipts were determined to be \$2,720.00.

Following the observation test, the auditor estimated Clone's sales tax liability for the period June 1, 1984 through August 31, 1984. The Saturday night admission price was \$7.00 (\$1.00 off with a V.I.P. card)¹, and the auditor assumed that the same number of customers went to the disco on Saturday nights as did on Wednesday nights. Thus, she calculated Saturday night admissions of \$1,416.00 and soda sales of \$144.00. The average of Wednesday and Saturday audited sales was \$2,140.00. A Newsday article published on July 15, 1987 stated that W. W. Flash was open on Friday, Saturday and Sunday nights, as did a recorded message. Also, the auditor knew that Clone provided catered parties at the disco and home catering but had no information with regard to the extent of the sales attributable to this business. Furthermore, the Division did not know when Clone stopped doing business as Feathers and began doing business strictly as a teen disco. The auditor assumed that sales of alcoholic beverages by Feathers would exceed soda sales by the teen disco. To account for these variables, she assumed that Clone did business seven days per week and had average daily sales of \$2,140.00. This was the basis for her calculation of audited quarterly taxable sales of \$194,740.00. To determine tax due from Clone, the auditor subtracted reported taxable sales from audited taxable sales and applied the sales tax rate to the difference. For the quarter ended August 31, 1984, these

¹The auditor mistakenly allowed \$2.00 off with a V.I.P. card and did not recognize the error until preparing for the administrative hearing.

calculations resulted in a sales tax liability of \$13,382.64, and notices of determination assessing that amount were issued.

After issuing the initial notices of determination, the Division continued its attempts to communicate with Clone's principals and accountant with regard to Clone's sales tax liability. Several phone calls were made to Mr. Koenig and to Bruce Filaski and flashers were mailed to Mr. Koenig in New York and in Florida. These attempts to contact Clone proved fruitless. Therefore, the Division determined Clone's sales tax liability for the period September 1, 1984 through August 31, 1987, using the methodology which it had employed to estimate tax due for the first sales tax quarter of the audit period.

Clone never provided the Division with any records or any information regarding its business practices. The Division obtained copies of Clone's 1983, 1984 and 1985 Federal income tax returns from the Internal Revenue Service after the notices of determination were issued. Petitioners placed in evidence Clone's 1986 Federal income tax returns. The returns show that Clone reported Federal gross receipts for the period April 1, 1984 through March 31, 1987 of \$338,418.00. For the period in issue, June 1, 1984 through August 31, 1987, Clone reported taxable sales to the State of \$210,796.00. When asked about this discrepancy under cross-examination, Mr. Koenig explained that he did not begin reporting admission receipts as taxable sales until sometime after the prior audit concluded. Mr. Filaski testified that he did not know when Clone began charging an admission. The prior audit found that Clone did charge an admission when it was operating Feathers.

Petitioners offered in evidence a set of register tapes collected by Bruce Filaski during the audit period. These consisted of five bundles of envelopes covering the period August 1984 through November 1985 and a sixth bundle covering the period March 1, 1986 through May 31, 1988. These records indicate that Feathers stopped serving alcoholic beverages on December 28, 1986 and began doing business strictly as a teen disco after that date. By and large the envelopes are dated, but there is no consistency in how the tapes were maintained. For instance, some envelopes purport to contain tapes for a single day while others purport to contain tapes

for a three-month period. The envelopes tend to show that Feathers did business on Friday, Saturday and Sunday nights. Two of the bundles have totals shown on the front which reconcile to reported taxable sales for corresponding periods. The other bundles were submitted without a summary. On their face, the envelopes which correspond to the period in which Clone was operating Feathers do not indicate whether admission receipts are included in the recorded figures.

The cash register tapes are of no use for purposes of determining Clone's taxable sales for the audit period. Neither Bruce Filaski nor Mr. Koenig could offer any information regarding Clone's recordkeeping procedures. Mr. Filaski stated that the cash register tapes were used as a basis for reporting sales, but he offered no worksheets, journals, ledgers or other documents which would enable one to reconcile the tapes to reported taxable sales. Furthermore, he was unable to answer any questions with regard to figures shown on the tapes.

Mr. Koenig prepared Clone's sales tax returns. He did not use the cash register tapes to do so (in fact, he testified that he never saw the tapes until the day of the hearing); rather, he reported taxable sales in an amount verbally provided to him by Mr. Filaski. Mr. Koenig reconciled Clone's checkbook and reviewed its bank statements. He prepared Clone's Federal income tax returns using his summaries of those records. The records relied on by Mr. Koenig to prepare the Federal returns were not placed in evidence.

Petitioner Bruce Filaski, William Filaski and Bradley Filaski conceded being persons responsible for collection of, reporting and paying over sales tax on behalf of Clone.

SUMMARY OF PETITIONERS' POSITION

Neither Mr. Koenig nor Mr. Filaski clearly articulated petitioners' objections to the audit methods or results. Mr. Koenig expressed his outrage at the Division's decision to estimate tax based on the observation test, rather than postponing the audit until he returned from Florida. Mr. Filaski testified that he never opened an envelope from a government agency but saved up all such communications until he saw Mr. Koenig which was every three to four months. He also stated that he called Mr. Koenig as soon as he became aware of the audit, in July 1987.

Mr. Filaski testified that his business began decreasing when New York State raised the legal drinking age and continued to decline until it was almost nonexistent. Clone then began operating as a teen disco. He offered little information with regard to the nature or level of Clone's business operations during the audit period. Apparently, it is petitioners' contention that the cash register tapes offered in evidence were an accurate representation of Clone's sales for the audit period; although petitioners never specifically made this argument.

CONCLUSIONS OF LAW

A. Where a taxpayer's records are inadequate to verify reported taxable sales, the Division is authorized to estimate the tax liability on the basis of whatever information is available to it, including external indices if necessary (see, e.g., Matter of Club Marakesh v. State Tax Commission, 151 AD2d 908, 542 NYS2d 881, lv denied 74 NY2d 616). It is clear that the Division had the right to resort to an external index to estimate tax due from petitioners. Petitioners made no books and records available, despite repeated requests by the Division. Moreover, the Division's refusal to postpone the audit does not excuse petitioners' failure to provide verifiable records of Clone's sales.

Persons required to collect sales tax have an affirmative duty to maintain verifiable records of their sales (Tax Law § 1135[a][1]) and to make those records available for inspection by the Division upon demand (Tax Law § 1135[d]). In view of petitioners' studied disregard of the Division's repeated messages and persistent attempts to schedule an audit appointment, it was not unreasonable for the Division to refuse to postpone the audit any further. Petitioners were given ample opportunity to provide records to the Division from April through the fall of 1987 and chose not to do so, thus forfeiting any claim they might have to object to the use of external indices to estimate their tax liability.

B. Where records of sales are not available, the Division is required to select an audit method reasonably calculated to determine the sales tax due (Tax Law § 1138[a][1]; see, Matter of W. T. Grant Co. v. Joseph, 2 NY2d 196, 206, 159 NYS2d 150, 157, cert denied 355 US 869). The burden is then placed upon the petitioner to prove by clear and convincing evidence

that the audit method or the amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 859, 446 NYS2d 451, 453).

C. A one-day observation test is not designed to bring about a precise determination of tax due, but precision is not required from an audit methodology where the taxpayer's own failure to maintain adequate books and records prevents exactness in calculating the tax liability (see, Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, lv denied 44 NY2d 645, 406 NYS2d 1025). Furthermore, such a methodology has been found reasonable where the taxpayer's records are undeniably inadequate to form the basis of an audit (see, Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679; Matter of Mera Delicatessen, Tax Appeals Tribunal, November 2, 1989; Matter of Gaetano Vendra, Tax Appeals Tribunal, February 9, 1989).

Petitioners presented no evidence which would show that the observation test itself was inaccurate. Although Mr. Filaski testified that the businesses operated by Clone were only open one or two nights per week, this testimony was contradicted by Clone's recorded message and the article in Newsday, indicating that the teen disco was open three nights per week. The envelopes containing cash register tapes establish that Feathers was also open three nights per week. Petitioners did not, even indirectly, allege any other error in the observation test. Instead, they introduced cash register tapes which were apparently intended as proof of their actual sales. By and large, the tapes were not dated. Summaries of the tapes were not provided. Testimony offered with regard to the tapes provided no information with regard to how the tapes were generated or maintained. No journals or ledgers were offered to enable reconciliation of the tapes to other records. Petitioners did not provide a reconciliation of the tapes to their filed sales tax returns. The tapes submitted for the period when Clone operated as Feathers do not show a separate statement of admission receipts, although the record indicates that Feathers charged an admission. Petitioners' accountant, who prepared Clone's sales tax returns, testified that he had never seen the tapes until the day of the administrative hearing. Accordingly, the cash register tapes are not acceptable as evidence of Clone's sales during the

audit period.

D. Precision is not required from the audit methodology when the taxpayer's own recordkeeping prevents it (Matter of Meyer v. State Tax Commn., supra); however, there must be a rational basis for the Division's calculations and sufficient facts in the record to enable an independent decision-maker to determine whether that rational basis exists (Matter of Grecian Sq. v. New York State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221; see also, Matter of Fokos Lounge, Tax Appeals Tribunal, March 7, 1991). Although the results of the observation test have not been shown to be unreasonably inaccurate, the use of those results to estimate total sales for the audit period is problematic. To determine audited weekly sales receipts (the base used to calculate sales per quarter), the Division multiplied seven times audited average daily receipts of the teen disco per the observation test ("daily receipts"). Rather than using a factor of seven times daily receipts, the audit methodology might be analyzed more productively by separating sales receipts into two broad categories: (1) daily admissions and sales of nonalcoholic beverages and (2) all others, including receipts from catering, private parties and alcoholic beverages sold by Feathers.

There is substantial evidence in the record supporting the conclusion that both Feathers and W.W. Flash conducted business three nights per week and charged admissions and sold nonalcoholic beverages on all those nights. Since the observation test included a calculation of actual admissions and nonalcoholic beverage sales, there is a rational basis for calculating sales from the first category of receipts based upon a factor of three times daily receipts.

The Division also used the results of the observation test to calculate sales from the second category of receipts, including catering, private parties and alcoholic beverages sold by Feathers. Essentially, these sales were estimated by using a factor of four times daily receipts. It is my conclusion that there is not a rational basis in the record for such a calculation. Home catering, private parties and alcoholic beverage sales are all items extrinsic to the observation test. Furthermore, there is no evidence showing the extent of sales receipts associated with these items. The auditor testified that Clone was offering catering services and that its premises

and services were sometimes rented for private parties, but she did not offer any reason for the Division's assumption that receipts from catering, private parties and alcoholic beverage sales by Feathers amounted to four times the daily receipts of the teen disco. While Bruce Filaski was not particularly forthcoming, his testimony is adequate to establish that parties catered by Clone at the teen disco were few, and there is no evidence in the record that contradicts that testimony. In accordance with these conclusions, the Division is directed to recalculate petitioners' tax liability, using three times audited daily receipts as the basis for its calculation of weekly sales.

E. Although the issue was not raised by petitioners, it is noted that the audit appointment letter dated June 12, 1987 identifies the initial audit period as June 1, 1984 through May 31, 1987. This audit period was later extended to August 31, 1987. The record shows that the Division continued in its attempts to contact petitioners and to seek books and records well into the fall of 1987. Petitioners rebuffed all communications from the Division. On this basis, it is concluded that the Division attempted to obtain books and records for the final quarter of the audit period and reasonably concluded that they would not be provided.

F. The petitions of Clone Enterprises, Inc., Bruce Filaski, William Filaski and Bradley Filaski are granted to the extent indicated in Conclusion of Law "D"; the notices of determination and demands for payment of sales and use taxes due issued on September 10, 1987 and December 20, 1987 shall be modified accordingly; and in all other respects, the petitions are denied.

DATED: Troy, New York

6/14/91

ADMINISTRATIVE LAW JUDGE